



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Reduction of Net Operating Loss Carryover under Section
382(l)(5)

This Field Service Advice responds to your memorandum dated December 15, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =

Debt1 =

Debt2 =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

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Date6	=
Date7	=
Date8	=
Date9	=
Date10	=
Date11	=
Pdate1	=
Pdate2	=
Year1	=
Year2	=
Year3	=
Year4	=
Year5	=
Year6	=
Year7	=
MonthA	=
MonthB	=
MonthC	=
\$aa	=
\$bb	=
\$cc	=
\$dd	=
\$ee	=
\$ff	=
\$gg	=
\$hh	=

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\$ii	=
\$jj	=
\$kk	=
\$ll	=
\$mm	=
\$nn	=
\$oo	=
\$pp	=
\$qq	=
\$rr	=
\$ss	=
\$tt	=
\$uu	=
\$vv	=
\$ww	=
\$xx	=
\$yy	=
\$zz	=
\$aaa	=
\$bbb	=
\$ccc	=
\$ddd	=
\$eee	=
%s	=
%t	=
%u	=

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%v =
 %w =
 x% =
 #m =

ISSUES:

1. Whether the amount of interest paid or accrued during the period on or before the change date of the taxable year in which the ownership change occurs is taken into account in computing the tax attribute reduction prescribed by I.R.C. § 382(l)(5)(B) if no net operating loss ("NOL") is incurred during that period.
2. Whether any "indebtedness for interest" should be taken into account in computing the attribute reduction prescribed by I.R.C. § 382(l)(5)(C) when additional debt instruments ("payment in kind" or "PIK" instruments) are issued in lieu of cash payments.

CONCLUSIONS:

1. The amount of interest paid or accrued by Taxpayer during the period on or before the change date of the taxable year in which the ownership change occurred should be taken into account in computing the tax attribute reduction prescribed by I.R.C. § 382(l)(5)(B), regardless of whether Taxpayer incurred any NOL during that period.
2. For purposes of I.R.C. § 382(l)(5)(C), the issuance of the additional PIK instruments is not a payment. Accordingly, any portion of the PIK instruments treated as interest on indebtedness converted to stock under I.R.C. § 382(l)(5)(B) should not be taken into account in determining the reduction under I.R.C. § 382(l)(5)(C).

FACTS:**First Bankruptcy**

During Year1, Taxpayer's creditors filed involuntary petitions with the United States Bankruptcy Court. Taxpayer subsequently filed a consent to the involuntary petitions and a joint plan of reorganization ("Plan 1"), which became effective in MonthB Year2. Under Plan 1, a substantial portion of Taxpayer's pre-reorganization debt was reduced by converting the debt into common stock. The

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remaining debt was replaced by two new issues of debt: (1) two series of Debt1 due Date1, Series A and Series B notes, and (2) Debt2 due Date2.

Distribution of the notes began on Date1, in an aggregate principal amount of \$aa – i.e., \$bb for Series A and \$cc for Series B. These notes were secured by substantially all of Taxpayer's assets. Interest on the Series A notes commenced as of Date4. Interest on the Series B notes commenced as of Date5. Interest for both Series A and B is payable semi-annually on Pdate1 and Pdate2. The first interest payments were due on Date6.

The Series A and B notes provide that Taxpayer, at its sole discretion, may issue PIK instruments in lieu of cash in satisfaction of all or any portion of interest due on the notes. On Date6, Taxpayer issued PIK instruments in lieu of cash interest payments due on that date. Taxpayer issued additional PIK instruments for all other interest amounts due through Date7.

For tax purposes, Taxpayer deducted interest determined under the OID provisions of I.R.C. §§ 163(e) and 1271-1275. In computing the issue price, the stated redemption price at maturity and the resultant OID amounts for the issues, Taxpayer assumed that it would exercise its option to issue PIK instruments rather than pay cash for the interest due.

Taxpayer filed a separate Form 8281 (Information Return for Publicly Offered Original Issue Discount Instruments) for the Series A and B notes because both series were issued with OID. The Forms 8281 stated that the Series A notes had OID in the amount of \$dd, and the Series B notes had OID in the amount of \$ee, for a total amount of OID of approximately \$ff through the maturity dates of the notes.

An attachment to Form 8281 for the Series A notes states that the issue price of each note was \$gg, and the stated redemption price at maturity ("SRPM") of each of the notes in Series A was calculated to be \$hh. The aggregate principal amount of the Series A notes was approximately \$bb. In the first year, the Series A notes provided for interest at an annual rate of %s, increasing to a rate of %t in the second year, %u in the third year, and %v in the fourth year. Interest on the Series A notes was payable on Pdate1 and Pdate2 of each year, and the first interest payment was payable Date6. Taxpayer could issue, solely at its discretion, PIK instruments in lieu of making cash payments on the Series A notes.

An attachment to Form 8281 for the Series B notes states that the issue price of each note was \$ii, and the SRPM of each of the notes in Series B was calculated to

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e \$jj.^{1/} The aggregate principal amount of the Series B notes was approximately \$cc. The Series B notes provided for interest at an annual rate of %w for a certain time, and at a rate of %v thereafter. Interest on the Series B notes was payable on Pdate1 and Pdate2 of each year, and the first interest payment was payable Date6. Taxpayer could issue, solely at its discretion, PIK instruments in lieu of making cash payments on the Series B notes.

Second Bankruptcy

In late Year5, Taxpayer realized that it was not going to be able to meet its obligations upon the maturity of the Series A and B notes due on Date1. On Date8, Taxpayer and #m of its subsidiaries filed a registration statement with the Securities and Exchange Commission that described a proposed restructuring plan to address this situation.

Under the proposed restructuring, Taxpayer planned to formulate a joint plan of reorganization with its major creditors and solicit their acceptances before the commencement of proceedings under chapter 11 of Title 11 of the Bankruptcy Code. The plan ("Plan 2") was filed with the Bankruptcy Court on Date9. The Bankruptcy Court approved Plan 2 in MonthA Year6, and Plan 2 became effective on Date10. Under Plan 2, the holders of Taxpayer's Series A and B notes received cash, new notes, shares of Taxpayer's common stock and other property. For financial accounting purposes, the canceled indebtedness for the Series A and B notes exceeded by \$ll the cash and the value of the new notes, stock and other property that the creditors received in exchange for those notes. Taxpayer recorded this amount on its books as an extraordinary gain.

On the date it filed Plan 2 with the Bankruptcy Court, Taxpayer discontinued, for financial accounting purposes the accrual of interest, including the amortization of recorded discount on the notes, in accordance with generally accepted accounting principles. The amount of accrued interest at that time (i.e., from the last payment date of Date7, to Date9) was \$mm. For tax purposes, however, Taxpayer continued to deduct the remaining OID through the Date1, maturity date.

Taxpayer's Reporting of the Reorganization under Plan 2

On its corporate tax return for Year6, Taxpayer reported that an ownership change, within the meaning of I.R.C. § 382(g), occurred when Plan 2 became effective on Date10, as a result of the issuance of the common stock to the creditors. However,

^{1/} This number on the attachment to Form 8281 was crossed out in handwriting and replaced with \$kk.

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because the ownership change occurred while Taxpayer was under the jurisdiction of the court in a title 11 proceeding, Taxpayer reported that it met the requirements of I.R.C. § 382(l)(5) and was not subject to a limitation under I.R.C. § 382(a). In accordance with I.R.C. § 382(l)(5)(B) and (C), Taxpayer reduced its pre-change NOL carryovers by \$nn. On its return for the Year7 tax year, Taxpayer revised the NOL reduction downward to \$oo. More recently, Taxpayer has submitted a memorandum dated Date11, prepared by its tax advisor, taking the position that the correct NOL reduction should be \$pp.^{2/}

According to Taxpayer's return, the total amount of debt discharged under Plan 2 was \$qq, of which \$rr was discharged by the issuance of stock having a value of \$ss.^{3/} As a result, \$tt (i.e., \$rr - \$ss = \$tt) of the debt was not satisfied.

In calculating the NOL reduction under I.R.C. § 382(l)(5)(B), Taxpayer determined that the following amounts of interest were deducted during its tax years Year3 through Year5 and the period in tax year Year6 before the change date:

Year3	\$uu
Year4	\$vv
Year5	\$ww
Year6 (pre-change)	<u>\$xx</u>
Total	\$yy

In calculating the amount of interest paid or accrued on indebtedness that was converted to stock under Plan 2, Taxpayer first determined that %x (i.e., \$rr ÷ \$qq) of the total indebtedness was converted to stock. On its return for Year6, Taxpayer applied that percentage to the entire \$yy of interest accrued during the Year3 through Year6 period to obtain \$zz as the amount of the attribute reduction under section 382(l)(5)(B). On its return for the Year7 tax year, however, Taxpayer did not take into account the interest accrued in Year6 prior to the ownership change on the ground that it did not incur any NOL during that period. On that basis, Taxpayer determined that the attribute reduction should be \$aaa. In the

^{2/} Taxpayer has not filed amended returns reflecting the decreased NOL reduction but has indicated its intent to do so as necessary.

^{3/} According to the information provided by Taxpayer, the creditors received \$bbb in cash (or cash equivalents) and \$ccc in new debt, leaving \$rr to be discharged by issuance of stock.

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memorandum of Date11, Taxpayer's tax advisor arrives at a revised attribute reduction of \$pp based on (i) excluding the interest accrued in Year6 prior to the change date and (ii) using a ratio derived by excluding the interest expense portion of the debt.

Issue 1. Interest Deductions Prior to Ownership Change

LAW AND ANALYSIS:

General

In the case of a loss corporation that experiences an ownership change, I.R.C. § 382(a) imposes a limitation on the amount of the corporation's post-change income that can be offset against its pre-change losses. However, if the loss corporation is under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change occurs, and if certain other requirements are satisfied, the limitation of section 382(a) does not apply. I.R.C. § 382(l)(5)(A).^{4/} Where this exception applies, the loss corporation must apply two reductions to its pre-change losses and excess credits, as prescribed by I.R.C. § 382(l)(5)(B) and (C). Your request raises issues involving each of these reductions.

Reduction of Loss Carryovers for Certain Interest Deductions

Section 382(l)(5)(B) requires a reduction for interest payments to creditors that receive stock in satisfaction of the indebtedness. Specifically, it provides as follows:

(B) REDUCTION FOR INTEREST PAYMENTS TO CREDITORS BECOMING SHAREHOLDERS. – In any case to which subparagraph (A) applies, the pre-change losses and excess credits (within the meaning of section 383(a)(2)) which may be carried to a post-change year shall be computed as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation on indebtedness which was converted into stock pursuant to title 11 or similar case during–

(i) any taxable year ending during the 3-year period preceding the taxable year in which the ownership change occurs, and

^{4/} The title 11 exception applies unless the loss corporation elects pursuant to I.R.C. § 382(l)(5)(H) and Treas. Reg. § 1.382-9(i) not to have it apply.

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(ii) the period of the taxable year in which the ownership change occurs on or before the change date.

On its return for tax year Year6, Taxpayer took into account the amounts of interest that it deducted during the three tax years preceding the tax year of the ownership change and also the amount of interest deducted in tax year Year6 prior to the ownership change. As indicated above, the total amount of those deductions was \$yy. Subsequently, on its return for tax year Year7, Taxpayer did not take into account the \$xx of interest deducted in Year6 on the ground that Taxpayer did not incur an NOL during that period. In support of that position, Taxpayer contends that “the plain language of Section 382(l)(5)(B) does not require a tax attribute reduction for Year6 because a net operating loss does not exist for Year6 and therefore cannot be ‘computed’ as if certain interest expense were not allowable.”

We disagree with Taxpayer’s interpretation of the attribute reduction rule of section 382(l)(5)(B). Although that provision specifically disallows a deduction for interest paid or accrued during the three taxable years preceding the taxable year of the ownership change and the period ending on the date of ownership change (collectively, the “three-year recapture period”), the language of the statute does not limit the effect of the provision solely to the three-year period.^{5/} Specifically, it refers to the computation of “*the pre-change losses and excess credits . . . which may be carried to a post-change year . . . as if no deduction was allowable . . . for the interest paid or accrued [in the three taxable years preceding the taxable year of the ownership change and the period in the taxable year of the ownership change preceding the change date] . . . on indebtedness which was converted into stock pursuant to [the] title 11 case . . .*” (Emphasis added.)

In our view, this provision affects the amount of *all* pre-change losses and excess credits that the loss corporation carries forward to post-change periods, not merely any losses or excess credits that happen to have been incurred during the specified recapture period. Thus, the computation under section 382(l)(5)(B) for any of the periods in the recapture period, disregarding any deduction for interest on indebtedness that was converted into stock, should generally result in a reduced deduction from income for that period.

Depending on the loss corporation’s particular income or loss situation for any given period, the reduction of the interest deduction may have one of three

^{5/} For convenience, this memorandum refers to the “three-year” period, even though the relevant period is generally more than three years since it includes the three taxable years before the taxable year of the ownership change plus the period during the taxable year of change ending on the change date.

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potential effects: (1) reduce the amount of the loss corporation's NOL for that period, (2) eliminate the loss corporation's NOL and create positive taxable income for that period, or (3) increase the loss corporation's taxable income for that period. Under Taxpayer's position, the reduced interest deduction would affect the amount of the loss corporation's NOL in situation (1) and in situation (2) to the extent of the reported NOL but would not have any effect to the extent of the loss corporation's income in situation (2) or in situation (3). Our reading of the provision would deem any unused NOL carryovers from the loss corporation's taxable years preceding the recapture period to be applied to the extent of any additional taxable income determined in situations (2) and (3). Since the loss corporation would have reported taxable income before the application of NOL carryovers in situation (3), it would presumably have offset any available NOL carryovers against that income on its return for that taxable year. After excluding a deduction for interest on indebtedness converted to stock in situation (3), the loss corporation's taxable income would generally increase, and any rational corporate taxpayer would normally apply any available NOL carryover to offset the additional taxable income. Accordingly, it is appropriate to deem such an offset in determining the effect of the reduction to the interest deduction in situations (2) and (3).

Our reading of section 382(l)(5)(B) is consistent with the legislative history of that provision. In particular, the Conference Report describes the effect of the provision as follows:

[T]he loss corporation's pre-change NOL carryovers are reduced by the interest on the indebtedness that was converted to stock in the bankruptcy proceeding and paid or accrued during the period beginning on the first day of the third taxable year preceding the taxable year in which the ownership change occurs and ending on the change date.

H.R. Conf. Rep. No. 99-841, at II-192 (1986), *reprinted in* 1986-3 (vol. 4) C.B. 192. This passage indicates that all of the loss corporation's pre-change NOL carryovers should be affected by the exclusion of interest on indebtedness converted to stock. Taxpayer's position would not achieve such a result since Taxpayer would reduce only the NOLs generated during the recapture period. In contrast, our view of section 382(l)(5)(B) would reduce not only any NOLs generated during the recapture period but also any NOL carryovers from periods prior to the recapture period, thereby fully implementing the quoted statement of legislative intent.

Determining Amount of Interest on Indebtedness Converted to Stock

On its return for Year6, Taxpayer determined that %x of the total pre-petition

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indebtedness was converted to stock pursuant to Plan 2 based on the ratio of the amount of indebtedness converted to stock (i.e., \$rr) over the total pre-petition indebtedness (i.e., \$qq). Taxpayer has subsequently suggested that the ratio should be determined without taking into account any of the PIK instruments for interest on the Series A and B notes. Taxpayer bases its revised ratio on the legislative history of a similar provision in legislation that was proposed in 1985 but was not enacted. Although Taxpayer reads the 1985 committee reports to mean that only the amount of the original indebtedness, without considering accrued but unpaid interest, we do not agree with Taxpayer's interpretation. Using Taxpayer's proposed ratio to determine under section 382(l)(5)(B) the amount of interest attributable to indebtedness converted to stock would fail to recognize the compounding effect of Taxpayer's deductions for interest on unpaid interest (under the PIK instruments). In effect, Taxpayer's revised ratio would yield only an amount of simple interest. In our view, Congress did not intend such a result. Accordingly, we do not believe Taxpayer's revised ratio is appropriate.

We recognize Taxpayer's concern that the ratio used in its Year6 return may not provide an accurate determination of the amount of interest deductions to be disallowed under section 382(l)(5)(B). In our view, a more accurate method of determining the amount of interest attributable to indebtedness converted to stock for purposes of section 382(l)(5)(B) may be available. Specifically, the method is suggested by Treas. Reg. § 1.1275-2(a), which provides a payment ordering rule for determining how to account for actual payments made by an issuer:

(a) *Payment ordering rule – (1) In general.* Except as provided in paragraph (a)(2) of this section, each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Thus, no portion of any payment is treated as prepaid interest.

We note that this regulation was adopted in 1994 and generally applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales and exchanges that occurred on or after April 24, 1994. T.D. 8517, 1994-1 C.B. 36. Therefore, this provision is not directly applicable to the debt instruments at issue, which were issued in MonthC Year2, and we need not address whether this regulation would necessarily apply. Thus, the following discussion merely uses the payment ordering rule as a guide in determining the amount of interest attributable to indebtedness converted to stock.

Using schedules attached to Taxpayer's Forms 8281, it is possible to construct a schedule of interest for each year of the Series A and B notes and the PIK

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instruments. Under the payment ordering rule of Treas. Reg. § 1.1275-2(a)(1), the payments of cash and notes under Plan 2 would be applied first against the oldest OID. The remaining \$rr of debt that was converted into stock consists of \$ddd of original principal and \$eee of OID arising in the accrual period ending Date1. From the schedule showing the amount of interest by year, it is possible to determine the amount of interest deductions taken during the three-year interest recapture period on the original principal amount that was converted to stock. (There would be no interest on the OID accrual.)

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

1. We note that your question assumes that the reorganization of Taxpayer pursuant to Plan 2 qualifies under I.R.C. § 382(l)(5) so that Taxpayer is not subject to a section 382 limitation after the reorganization. For purposes of this memorandum, we have made the same assumption but point out that the requirements of I.R.C. § 382(l)(5)(A)(ii) and § 382(l)(5)(E) must be satisfied in order for Taxpayer to avoid the application of I.R.C. § 382(a).
2. Although the method described above for determining the amount of interest subject to recapture under section 382(l)(5)(B) may be more precise than Taxpayer's ratio method, we point out that Treas. Reg. § 1.1275-2(a)(1) does not apply to the Series A and B notes at issue in this case. There was no payment ordering rule in effect when the Series A and B notes were issued in MonthC Year2 to require the taxpayer to first allocate its cash or other payments made to OID, and then to outstanding principal. Because there are no regulations directly applicable to the Series A and B notes, under either section 382(l)(5) or the OID regime, a court may permit Taxpayer to use any reasonable method to determine the amount of interest attributable to indebtedness converted to stock. See *Gottesman & Co. v. Commissioner*, 77 T.C. 1149, 1157-1158 (1981).
3. We have assumed that the PIK instruments at issue were issued in lieu of cash payments of interest. We have also assumed that the Series A and Series B instruments were issued with OID, and we have assumed the correctness of the OID calculations. If, upon additional factual development, it is determined that the PIK instruments were not issued in lieu of cash payments of interest, that the Series A and Series B instruments were issued without OID, or that the OID calculations were incorrect, please contact us for additional assistance.
4. The facts state that Taxpayer continued to deduct the remaining OID through Date1, maturity date after filing its plan of reorganization on Date9. We point out, however, that an issuer may not generally deduct under section 163 interest, including OID, on unsecured prepetition debt instruments after the issuer files a

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petition for bankruptcy under Title 11 and while the issuer remains in bankruptcy. See LGM TL-103.

Issue 2. Reduction to NOL under I.R.C. § 382(l)(5)(C)

In addition to a reduction of the loss corporation's NOL carryovers under section 382(l)(5)(B), a corporation qualifying under section 382(l)(5)(A) must also reduce its NOL carryovers pursuant to section 382(l)(5)(C). As applicable in 1984, section 382(l)(5)(C) provided as follows:

(C) REDUCTION OF TAX ATTRIBUTES WHERE DISCHARGE OF INDEBTEDNESS –

(i) **IN GENERAL.** – In any case to which subparagraph (A) applies, 50 percent of the amount which, but for the application of section 108(e)(10)(B) would have been applied to reduce tax attributes under section 108(b) shall be so applied.

(ii) **CLARIFICATION WITH SUBPARAGRAPH (B).** – In applying clause (i), there shall not be taken into account any indebtedness for interest described in subparagraph (B).

As applicable in Year6, section 108(e)(10)(A) generally provided that a debtor corporation that transfers its stock to a creditor in satisfaction of its indebtedness is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. Under this rule, the debtor corporation would have discharge of indebtedness ("COD") income equal to the difference between the amount of the discharged debt and the fair market value of the stock issued to the creditors. Section 108(e)(10)(B), however, provided an exception to this general rule in the case of any transfer of the debtor's stock (other than so-called "disqualified stock" not relevant here) by a debtor in a title 11 case. Nevertheless, in applying section 382(l)(5), subparagraph (C) required the debtor corporation to reduce its pre-change loss carryover by 50 percent of the COD income that it would have recognized if section 108(e)(10)(A) were applicable, not taking into account any indebtedness for interest described in section 382(l)(5)(B).

In the instant case, Taxpayer issued stock having a purported value of \$ss to discharge indebtedness of \$rr. Taxpayer would have had \$tt of COD income under section 108(e)(10)(A) if it had not been excepted from that provision by section 108(e)(10)(B) as a debtor in a title 11 case. Under clause (ii) of section 382(l)(5)(C), any indebtedness for interest described in section 382(l)(5)(B) is not taken into account in determining the amount of COD income for purposes of

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section 382(l)(5)(C). On the basis of clause (ii), Taxpayer reduced the amount of COD income by all of the interest on indebtedness converted to stock, as determined under section 382(l)(5)(B), and then multiplied the remaining COD amount by 50 percent to obtain the reduction under section 382(l)(5)(C).

Your request seeks advice on whether the PIK instruments should be treated under section 382(l)(5)(C)(ii) as “indebtedness for interest described in [section 382(l)(5)(B)]” – i.e., whether Taxpayer correctly eliminated all the interest on indebtedness converted to stock taken into account under section 382(l)(5)(B) from the amount of COD income that it would have had to recognize under section 108(e)(10)(A) if it had not been exempt under section 108(e)(10)(B).

The adjustment under section 382(l)(5)(C) was first adopted as part of the overall amendment of section 382 in the Tax Reform Act of 1986 and did not originally contain clause (ii) relating to indebtedness for interest described in section 382(l)(5)(B). Section 1006(d)(18) of the Technical and Miscellaneous Revenue Act of 1988 amended subparagraph (C) to include clause (ii), as quoted above. The committee reports explain this amendment as follows:

The bill clarifies the attribute reduction that occurs with respect to amounts that would be cancellation of indebtedness income. The amount of the reduction is 50 percent of the amount that (but for section 108(e)(10)(B)) would have been applied to reduce tax attributes under section 108(b), that is, the excess of the amount of cancelled debt over the fair market value of stock issued in satisfaction of the debt. The bill also clarifies that *the amount of the debt outstanding for this purpose does not include previously accrued but unpaid interest that has already been deducted from net operating loss carryforwards* under the rule requiring reduction for interest deducted during the three-year period prior to the ownership change.

H.R. Rep. No. 100-795, at 51 (1988) (emphasis added); *accord*, S. Rep. No. 100-445, at 53 (1988).

The statutory language of clause (ii) and the explanation quoted above suggest that the purpose of clause (ii) is to avoid duplicative adjustments under subparagraphs (B) and (C). The adjustment under subparagraph (B) effectively reduces the loss corporation’s NOL carryovers by the amount of interest deductions paid or accrued during the three-year recapture period on indebtedness converted to stock. Accordingly, to avoid reducing the NOLs again by any amount of the interest taken into account under subparagraph (B), clause (ii) excludes from the determination of COD income under subparagraph (C) any indebtedness for such interest.

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Under the OID regime, the OID accruals have the effect of increasing the amount of debt. This is illustrated by the final regulations under section 1272 that provide rules for determining the tax treatment of notes that provide for the payment of interest by issuing PIK instruments. Treas. Reg. § 1.1272-1(j), Examples 7 and 8, provide examples for debt instruments issued at par and issued at a discount that provide for payment of interest in kind. Example 7(ii) provides the rule that, “Under § 1.1275-2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument.” Pursuant to Treas. Reg. § 1.1272-1(j), Example 7(iii), “The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity.”

Pursuant to Treas. Reg. § 1.1272-1(j), Example 8(ii), “Under § 1.1275-2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument.” Additionally, pursuant to Treas. Reg. § 1.1272-1(j), Example 8 (iii), “The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity.”

Treas. Reg. § 1.1275-2(c)(3) provides the following:

[T]he payments made pursuant to an additional debt instrument are treated as made on the original debt instrument, and the distribution by the issuer of the additional debt instrument is not considered to be a payment made on the original debt instrument. . . . See § 1.1272-1(c) for the treatment of certain rights to issue additional debt instruments in lieu of cash.

These regulations were adopted in 1994 and generally apply to debt instruments issued on or after April 4, 1994, and to lending transactions, sales and exchanges that occurred on or after April 24, 1994. T.D. 8517, 1994-1 C.B. 36. Therefore, these regulations are not directly applicable to the debt instruments at issue, which were issued in Month C Year 2. However, generally, it is the Service’s position that the issuance of the PIK instrument is not a payment for purposes of the OID statutes.

In the instant case, Taxpayer deducted the accrued OID pursuant to section 163(e) from the time that the OID began to accrue through maturity. Taxpayer is not treated as having “paid” interest or the OID by issuing the PIK instruments for purposes of section 382(l)(5)(C).

Although the PIK instruments were issued when interest was due on the Series A

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and B notes, they are debt instruments that effectively increased the amount of Taxpayer's indebtedness under the Series A and B notes. As a result, the PIK instruments constitute a portion of Taxpayer's total debt that was discharged in the bankruptcy reorganization. Clause (ii) of section 382(l)(5)(C) provides that "indebtedness for interest described in subparagraph (B)" is not taken into account for purposes of determining the COD income adjustment under clause (i) of subparagraph (C). The interest described in subparagraph (B) is "interest paid or accrued on indebtedness which was converted into stock" during the three-year recapture period. Thus, the effect of clause (ii) of subparagraph (C) is to exclude from the determination of COD income any interest that was accrued but not paid during the three-year recapture period. (Any such interest that was actually paid would not be a debt and thus would not affect COD income.)

In the instant case, Taxpayer issued the PIK instruments in lieu of making cash payments. Because the PIK instruments were not paid prior to Taxpayer's bankruptcy petition, they constituted a portion of the total debt discharged in the bankruptcy reorganization. Thus, any PIK instruments issued during the three-year recapture period represent "indebtedness for interest described in subparagraph (B)" and would be included in the determination of the reduction of NOL carryovers under subparagraph (B). Accordingly, based on our reading of subparagraph (C), we believe that the issuance of the PIK instruments should not be taken into account in determining the amount of COD income under subparagraph (C).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

1. Your memorandum notes an alternative position based on the payment ordering rule of Treas. Reg. § 1.1275-2(a). Under this position, the amount of unpaid interest would be \$██████████, of which only \$██████████ relates to interest on the original principal. Although this position appears to be a reasonable approach and is consistent with the approach discussed under issue 1, we reiterate our concern that the payment ordering rule was not adopted until 1994 and is not directly applicable to the Series A and B notes, which were issued in MonthC Year2.
2. We note that Taxpayer has relied on the final OID regulations under Treas. Reg. § 1.1275-2 for the position that the issuance of the PIK instruments is not a payment of the accrued but unpaid interest. It is not clear that Taxpayer has applied these regulations correctly or that Taxpayer's application of these regulations has any continuing relevance in light of our conclusion concerning section 382(l)(5)(C). To the extent that the taxpayer has correctly applied the final regulations, we advise that you not pursue the issue and not litigate against the final regulations. We would be pleased to provide additional assistance on this issue.

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3. Your memorandum references a discussion in TAM 9538007, which considered whether the “doubtful collectibility” exception to the general accrual rules should apply in the case of OID interest accrual under I.R.C. § 1272. The TAM indicates that the statutory regime for OID deems a payment of OID (in lieu of actual payment) to the creditor, who is then deemed to lend that same amount back to the debtor. In light of our discussion of section 382(l)(5)(C) above, we conclude that the TAM is not relevant for the purposes of this FSA.

If you have any further questions, please call (202) 622-7930.

Deborah A. Butler
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By: _____
ARTURO ESTRADA
Acting Chief
Corporate Branch

cc: Assistant Regional Counsel (LC)
Assistant Regional Counsel (TL)